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**One day the mist will clear and the collective delusion of effortless wealth creation will be shattered.
Until that day, we are living on borrowed time.**

Debt and Delusion, Peter Warburton
Allen Lane, Penguin Press, 1999

DENIAL AND DELUSION

To so-called optimists, the Fed's surprising fourth rate cut in little more than a hundred days was a perfectly timed move that finally lit the fire of recovery under the sputtering U.S. economy. To the so-called pessimists, it was another act of desperation, reflecting just how weak the U.S. economy has become and how worried the policymakers in Washington are. Another Fed rate cut by 50 basis points at its May 15 meeting already seems a foregone conclusion.

Brickbats are flying across the Atlantic. As economic growth slows the world over, the European Central Bank gets heaps of advice with increasing vigor, particularly from America, to join the Fed in cutting interest rates. ECB president Wim Duisenberg, however, as he put it recently, hears but he doesn't listen.

This wrangling about European monetary policy probably reflects fundamentally different policy approaches, very different perceptions of risk and very different perceptions of a global role. Putting it bluntly: Fed Chairman Alan Greenspan and Wall Street are desperate, Mr. Duisenberg is not, and what happens on Europe's bourses is not among his concerns. His main mistake, and that of many people in Europe, we presume, is complacency — not about Europe's economy but about the American economy. Greenspan's vision of a "garden-variety" inventory recession to be followed by a quick rebound has also found many believers in Europe, even in the European Commission. From this key assumption flows the conclusion that any global contagion will be limited.

Trying to judge the outlook for the U.S. economy, it is important to explore the nature of the downturn. Given the enormous imbalances and distortions that have built up in the United States during the past bubble years, the purging of these excesses is sure to take several years. Fighting this downturn with rate cuts resembles Don Quixote's lance attack against the windmills.

What we are witnessing in the United States is far more than the bursting of the Great Bubble. It is the bursting of the whole new paradigm myth claiming that widespread and aggressive investment in new information technology created profit and productivity miracles. The reality was massive malinvestment and capital destruction. The main source and instrument of this delusion was hedonic price indexing. In this letter we explain our principal objection to this measuring rod.

Wall Street visionaries may have failed to call the economy's sharp downturn and the collapse of the technology stocks, but they are out in full force trumpeting that they see the bottom. Abby Josph Cohen of Goldman Sachs has been urging everyone to buy stocks again, raising her recommended stock allocation from 65% to 70%. "We think the profit deceleration is largely over," she said. Credit Suisse First Boston's Tom Galvin is proclaiming that this is the best buying opportunity for stocks, and Merril Lynch is running a massive print campaign with full-page ads claiming that the markets "are now close to bottom."

Considering what is financially at stake for those succumbing to these siren songs, one implicitly thinks that the playwrights would feel obliged to offer some explanation of what, in their view, is ailing the U.S. economy and what exactly is leading them to forecast an imminent big rebound in the stock market. But macroeconomic

analysis finds very little interest on Wall Street. The simplistic consensus is that the U.S. economy, while the healthiest and strongest in the world, is experiencing a temporary, mainly inventory-related, slowdown, mostly due to the fact that the Fed went one or two interest rate hikes too far. Nobody finds it strange that this alleged monetary tightness went together with a very rampant credit expansion.

For those who regard the Fed's rate hikes as the U.S. economy's main problem, this disease is easily treated by a few more rate cuts, essentially the faster the better. Mr. Greenspan complied with a speed that has no precedent. The closest experience to it was in 1991, when the Fed cut its Fed funds rate by 275 basis points, from 6.75% to 4%. But those took place over a period of 12 months in 10 increments, not even close to what has been done in the past three-and-a-half months.

There was not a soul on Wall Street who had expected another rate cut by 50 basis points so quickly. The big question was: why now? Given some better-than-expected economic news, the timing of the rate cut showed signs of urgency. To some observers it suggested that the Fed was more concerned about development than the markets. In fact, that's what the Fed even explicitly indicated in its press release: "*A significant reduction in excess inventories seems well advanced. Consumption and housing expenditures have held up reasonably well, though activity in these areas has flattened recently.*"

But the clue to what induced its hand were some carefully crafted words over capital spending and profits: "*Nonetheless, capital spending has continued to soften and the persistent erosion in current and expected profitability in combination with rising uncertainty about the business outlook seems poised to dampen capital spending going forward. This potential restraint, together with the possible effects of earlier reductions in equity wealth on consumption and the risk of slower growth abroad, threatens to keep the pace of economic activity unacceptably weak.*" In other words, the Fed worries in particular about profits and fixed capital spending. That's a far cry from an inventory recession.

Coming from a central bank, this was pretty strong language, comparing ominously with the rather cheerful communications from Wall Street strategists, chart technicians and analysts proclaiming almost in unison to see a "bottom." In a way, the Fed's message sounded very much like a phrase that has become quite common for tech industry leaders: *We have poor visibility into the duration and breadth of the current economic downturn.* In other words, they feel at a loss to reasonably assess the outlook for their own firms and the economy as a whole. They are shellshocked.

Compared to the torrent of disastrous profit announcements and downbeat statements from Corporate America, Wall Street-inspired sentiment in the markets appears strangely complacent. It is still widely assumed that the U.S. economy is experiencing no more than a short pause in growth in the first half of this year before bouncing back in the second — a strong V-shaped recovery — thanks to the Fed's aggressive interest rate cuts. Typical of this mentality was what happened to Intel's stock when the company announced that profits in the first quarter had plunged by 82%. Its stock jumped as much as 12% as reported revenue beat Intel's sharply reduced estimates.

THE VITAL DISTINCTION

The still prevailing optimism about the U.S. economy rests on three chief assumptions: *first*, that the downturn is being driven by the technology industry, which is suffering a major inventory correction; *second*, that consumer spending, accounting for 75% of GDP growth, will prove resilient and thus prevent recession; and *third*, that prompt and aggressive monetary easing by the Fed cannot fail to work its magic on the markets and the economy.

We vehemently disagree on all three counts. The technology sector's woes are not simply a matter of a temporary decline in demand and inventory correction. What we are witnessing is the complete dismantling of America's "new paradigm" economy. Of the many miracles that have been assigned to the New Information Technology, one after the other is proving fallacious.

Just think of the various popular assertions in this respect: that the new technology is immune to the business cycle; that it forestalls recessions by preventing unintended inventory building through real-time monitoring; that it boosts business profits and productivity to unprecedented levels. Ironically, the high-tech sector, which has crucially propelled the U.S. economy's growth during the past few years, is not merely weakening, it is collapsing. And don't forget, during the last five years it accounted for one-third of real GDP growth.

As for the hope that sustained consumer spending will save the U.S. economy from recession, we refer to recent issues of this letter in which we stressed the consumer's rapidly growing financial plight. Consider his record-high indebtedness, his rapidly dwindling paper wealth in the stock market and last but not least the fact that his real disposable income is stuck in prolonged stagnation, with worse unquestionably in the offing.

What about America's ample monetary and fiscal ammunition? Most American economists have an almost religious faith in the power of a central bank to stop an economy from slipping into severe recession. The Fed certainly has more scope to cut interest rates and taxes than today's Japan. But Japan, too, had plenty of scope to do both in 1990, when interest rates were high and the government ran a budget surplus that was even higher, measured as a share of GDP, than that in America today. But the Bank of Japan was slow to cut interest rates because its economy continued to boom for almost two years after the bursting of the bubble.

In comparison, the U.S. economy's slowdown has been extreme by any standard. Boom turned to bust in less than six months. The high-tech sector is virtually collapsing. While this uncommon economic weakness spurred the Fed's quick rate cuts, it can hardly be counted as something positive. Principally, it rather points to unusual fragility on the U.S. economy's part. Monetary easing has worked most of the time, but definitely not all the time. What's more, it is well-known what makes the difference: the cause and pattern of the downturn.

Sorry, we have explained it several times before, but now it happens to be the most important issue not only for America, but for the whole world. The severe and protracted recessions that regularly defy monetary easing for a prolonged period are invariably the upshot of a prior, pervasive "bubble economy" — the age-old phenomenon in which soaring asset prices stoke borrowing and spending binges in investment and consumption that burst once asset prices decline. It has been labeled a "post-bubble recession," in contrast to the garden-variety inventory recession. The distinction is vital. There is no question that the current U.S. economic downturn belongs to the "post-bubble" type. Measured by the phenomenal extent of the prior borrowing and spending excesses, it has been the greatest bubble in history, which rather raises the question whether new and still greater credit excesses are at all desirable.

It is our long-held opinion that the U.S. economy is relentlessly heading for a very deep and protracted recession, simply because the unsustainable borrowing and spending excesses that have accumulated during the boom require major, painful readjustment processes. This is logical. But many people, among them certainly Mr. Greenspan, think that improvements derived from the new technology, in particular higher productivity growth and greater flexibility, will mitigate the woes of recession.

Many times in these letters we have expressed our disbelief in the productivity miracle generally attributed to the new information technology. Considering the unfolding profit disaster in the high-tech sector, and considering further that the worst stories of excess inventory accumulation involve companies selling the very information systems that were supposed to make "real time" management possible, we think it's time to profoundly reassess the merits of this technology. Could all the miracles ascribed to the extensive use of this technology have been nothing but hype and mania?

THE AMERICAN PROFIT MYTH

On March 29, the U.S. Commerce Department published its final GDP report for the fourth quarter of 2000. Showing only insignificant changes in comparison to the previous report, it attracted virtually no attention in the markets and among economists. Nevertheless, it contained a bombshell. As this report, according to

schedule, was to bring the profit numbers for the fourth quarter specified by industry groups, we were eagerly looking forward to its publication.

What we discovered were numbers that surpassed our worst expectations. Due partly to higher profits of U.S. subsidiaries abroad and partly to gains by the financial sector, the aggregate looked rather better. But the part of the total that is crucial for economic activity, to wit, the whole of nonfinancial Corporate America, revealed a decline in domestic profits of a steepness that essentially suggested a dramatic deterioration in the economy.

Aggregate profits (before tax) of the sector, including high-tech, have plummeted by \$75.6 billion, from \$602.9 billion to \$527.3 billion. Annualized, that's a slide by 50%. What's more, it has happened across all sectors. Worst hit, though, is manufacturing, with profits down from \$192.1 billion to \$152.4 billion. At this level, U.S. manufacturing has been earning substantially less than the \$166.1 billion in 1995. Listening to proliferating CEO warnings about revenues and profits, it's clear that the worst has hardly started.

And how did the economists, analysts and markets respond to these dreadful profit figures? In brief, they attracted zero attention. Considering that just two days earlier Wall Street had soared in reaction to the news of an eight-point rise in the Conference Board's consumer confidence index, to 117, one can only wonder about the intelligence and integrity of those who are supposed to carefully analyze and comment on economic developments.

Contemplating Corporate America's actual, poor profit performance over the past five boom years, we ask ourselves whether any financial analyst selling the notion of a productivity and profit miracle to the investing public has ever bothered to check the official figures from the Commerce Department's National Income Accounts. He would have noticed a preposterous difference between his euphoric message and the pitiful reality of the official data.

Observing this, we have to point out that our focus is on *domestic profits of the nonfinancial sector*, where the great benefits of the productivity miracle ought to be concentrated. Particularly remarkable is, of course, the absolutely disastrous profit performance of manufacturing. Where else than there, embracing the economy's high-tech component, should the trumpeted "new paradigm" miracle materialize in the first place?

PITIFUL REALITY

Here the hard facts for the period from 1995 to the fourth quarter of 2000: Total domestic profits of nonfinancial businesses rose from \$403.8 billion in 1995 to \$527.3 billion, annualized, in the fourth quarter of 2000. This represents an overall increase by 30.6%, or an annual average of 6.1%. By the way, half of that increase happened in 1995. To put this rate of profit growth in perspective, it coincided with 36% overall growth of nominal GDP during this period. Profits grew less than nominal GDP, and that definitely qualifies as subpar. Considering moreover that this period covered nothing but boom years, it is an outright pitiful profit performance.

The long-run rule is that profit growth tracks nominal GDP growth, but does so with cyclical modifications. During boom years, profits normally run ahead of nominal GDP growth; during years of weak economic growth, they usually lag behind. In light of this rule, the profit performance since 1995 appears most miserable.

Assessing this poor profit performance, keep in mind that the prolonged, sharp rise in stock prices immensely bolstered reported corporate earnings mainly through three different channels: *first*, through gains from the sale of corporate equity investments; *second*, from heavy use of stock options as a substitute for wage expenses; and *third*, from the general funding of employee pension plans through stock market gains. In the same vein, it should be clear that these major, outside profit sources are turning negative with falling stock prices.

Comparing these poor profit figures with the Wall Street euphoria about a productivity and profit miracle,

most people, we assume, will not trust their eyes. Therefore, we explicitly repeat: These are readily available official numbers from the Commerce Department's National Income Accounts. It strikes the eye as rather strange that this dramatic profit deterioration happened against the backdrop of accelerating and record-high GDP growth in chained dollars.

Spectacular earnings growth effectively happened from 1991 to 1994, and this had three obvious reasons: *first of all*, it started from a recession-depressed base in 1991; *second*, earnings benefited overwhelmingly from rising capacity utilization, plunging corporate interest expenses, and *third*, from a falling dollar. That is, the profit bonanza of the first half of the 1990s was just cyclical. Ironically, 1995 is the inflection point where the actual, stellar profit performance ended and the stellar profit illusions of the New Economy started.

CORPORATE PROFITS BY INDUSTRY GROUP (BEFORE TAX, BILLIONS OF DOLLARS)						
	1995	1996	1997	1998	1999	2000
Domestic industries	650.2	729.4	800.8	775.1	813.9	940.5
Financial	154.3	165.3	185.7	164.8	172.0	195.5
Nonfinancial	403.8	463.3	504.5	506.8	530.4	602.9
Manufacturing	166.1	181.2	195.2	177.4	181.6	192.1
Transportation*	85.3	91.4	85.9	83.9	88.4	103.1
Wholesale trade	29.4	42.6	49.2	56.4	56.7	21.1
Retail trade	44.1	52.9	63.9	76.6	81.5	91.8
Rest of the world	100.9	110.7	103.5	111.4	142.1	159.4
Increase in %**	9.4	14.7	8.9	0.5	4.6	8.9
						-4.3

* Transportation and utilities, ** Profits of nonfinancial sector
Source: Department of Commerce, Survey of Current Business

FRAUD

It is our long-held opinion that the prevailing high-pressure shareholder-value culture, with its fantastic rewards for higher share prices, intrinsically invites and provokes abuse, particularly since nobody cares about underlying causes. There are far too many ways to manipulate numbers, perceptions and expectations if corporate management, accountants and investment analysts readily collaborate. And they have done so intensely. Striving for higher shareholder value is thought to justify almost any means. Expressing it rather more bluntly: many of the methods used were outright fraudulent. If you think that all these artifices served the purpose of luring people into the purchase of ridiculously overvalued stocks, it appears quite reasonable to speak of criminal fraud.

In the name of shareholder-value capitalism, business mores in the United States went overboard as never before in history. Bending as many accounting rules as possible has been accepted as a way of life. Given a common, overwhelming interest in higher stock prices, voices of protest or criticism were extremely rare. Or think of the crude trick with "guided" profit expectations. Reporting that profits exceeded expectations just "by a penny" was so common that this practice became painfully ridiculous to the onlooker. But nobody in the higher ranks of Wall Street called for a halt to this disgraceful stupidity. Nor did anybody outside of Wall Street.

All this worked magnificently in creating the perception of an economy accomplishing all kinds of miracles. Here are two random, typical quotations, both little more than a year old. *Business Week*: "More than anything else, the surge in the profitability of American corporations has been the root of the U.S. stock market's incredible run in recent years." Or the *Bank Credit Analyst*: "The U.S. model of aggressive restructuring, supply-side reform and widespread application of new technologies has paid off in an extraordinary period of strong economic growth, low inflation and a surging equity market. Will this experience be replicated in Europe and Asia?"

Again, we point to the table on page 5, exhibiting the actual, poor U.S. profit performance since 1995. While everybody kept talking about a profit miracle reflecting the equally famous productivity miracle, we can only insist that the official statistics flagrantly contradict this general perception. As we remarked earlier, 1995 does, indeed, stand out as an inflection point for the U.S. economy, but one very different from what most people think. That year was in reality the juncture where the former, superior profit growth turned into a prolonged, subpar performance. How is such general deception possible? Well, just think of Hans Christian Anderson's fairy tale of the Emperor's nonexistent new clothes that everybody admired.

The U.S. profit miracle of the late 1990s is just another fairy tale. Every speculative mania in history has been driven by the very same two forces: inordinate credit excess and a fairy tale of future exorbitant profits used to justify lofty asset prices.

While stock prices soared to ever more absurd levels, the Wall Street bulls never stopped to predict more and more of the same. Historical valuation measures went out the window with the argument that Corporate America's new paradigm qualities in profit and productivity performance justified stratospheric levels of Wall Street prices.

Our profit table on page 5 has made it painfully clear that for years Wall Street has been celebrating a profit boom that never happened. We mentioned some of the tricks how the investing public was deluded. In essence, they boiled down to outright fraud, if not criminal fraud. Yet this leaves us with the further question of how this generally crude disinformation was possible in the great Age of Information. Isn't it one of Mr. Greenspan's great arguments that today's perfect information essentially begets perfectly efficient markets and perfect decisions?

But fast and comprehensive availability of information is one thing; scrutinizing and exploiting it is an entirely different thing. For more than 40 years now we have witnessed and participated in the global economic discussion. Never before have we encountered such gross misinformation and also such gross ignorance in elementary economics as today.

MORE DISINFORMATION

In actual fact, the great disinformation continues. Only it's no longer about the wonders of a new paradigm economy. This time, it's about the malign pattern of the U.S. economy's current downturn and its inherent risks. As we have repeatedly stressed, there are principally two different kinds of recession. There is the garden-variety type largely reflecting the correction of excessive inventories, and there is the "post bubble" or "boom-bust" type, being by nature akin to the U.S. Depression of the 1930s and Japan's current prolonged recession.

As already pointed out, the official data do not allow any doubt that the present U.S. downturn belongs to the latter, very dangerous type. And just as clear is its origin. It was preceded by the world's most insane credit explosion and asset bubble. A table in the March letter showed in detail that the related spending excesses occurred overwhelmingly in consumer and business fixed investment spending. Not surprisingly, that's where the economic slowdown is centered, while business inventories continue to rise at a fast clip. There has been nothing like it in the whole postwar period.

Mr. Greenspan, for sure, knows the ugly truth of what is ailing the U.S. economy. Nonetheless, he chose in a recent congressional testimony to describe the economic downturn as a garden-variety inventory correction, accruing from an unusually rapid inventory adjustment. Unfortunately, this rapid real-time inventory adjustment has occurred only in Mr. Greenspan's fantasy. Ironically, heavy inventory building is the one thing that has so far forestalled recession in the United States. Though some lonely voices have contradicted Mr. Greenspan, the consensus readily sticks to the bogus version of an inventory correction. It is the essential condition that allows to predict the economy's recovery.

In the same testimony, Mr. Greenspan also elaborated on the danger of a break in confidence. We would say that America's key economic problem today lies in the fact that collective income and profit expectations

in the past boom years had been inflated to unsustainable levels of manic euphoria, from which they essentially have to come down.

From what we commonly read, it appears that confidence, in particular for the longer run, remains unduly high. Just consider that the consumer, although confronted with rapidly worsening finances, has maintained spending growth by heavy borrowing. Why should he retrench if all the experts tell him that the current economic slowdown is merely a quickly passing inventory correction? Nevertheless, spending has also slowed, though much less than real income growth.

DON'T BET ON THE CONSUMER

Owing to a big jump in January, first-quarter real consumer spending may be on track to grow at a 3% annual rate, after 1.88% in the fourth quarter. But we suspect that this spurt has more to do with a distortion in seasonal adjustment. Don't let these numbers unduly impress you. Figures for February and March are lousy. Most of their strength derives from the American practice of annualizing certain figures. Still, in light of the relentless carnage in the stock market and virtual stagnation in real disposable personal income, consumer spending has held up amazingly well. It's the most amazing feature in this scenario.

A resilient consumer is the great hope of those who are still venturing that a U.S. recession may be avoided. Don't bet on it. Due to the inordinate availability of consumer credit since the 1920s, the American consumer plays a major role in the U.S. business cycle. He essentially makes booms bigger and longer, but also makes busts deeper and more pervasive. In the aftermath of the 1929 crash, debt-laden consumers sharply pulled back on spending. Far from offsetting any drop-off in business investment, the steep declines of both cumulated. We have no doubt that today's consumer, who has negative savings and is far more debt-laden than his ancestor in the 1930s, has no choice financially but to follow suit in due time.

Within 12 months the U.S. stock market has wiped out \$4.4 trillion of investors' wealth. As for consumer income, real disposable income only rose 0.1% month-over-month in February, just offsetting an equal decline in January. Although the unemployment rate has hardly risen, hours worked have been cut back sharply. While businesses have been promptly responding to the earnings implosion, so far the consumer remains steeped in denial.

Looking only at the last two years from fourth quarter 1998 to fourth quarter 2000, he slashed his saving rate from 3.8% to negative 0.8% of disposable income. Adding up to about \$300 billion, this spending flow from dissaving compares with total nominal consumer income growth of \$890 billion during these two years. That is, fully 25% of the growth in consumer spending has come from dissaving. And all this happened in the face of savage losses in the stock market.

In our view, the negative personal saving rate is the darkest cloud hanging over the U.S. economy. With consumer finances pretty much in tatters and overwhelming prospects for worse to come, the fitting question to ask is when and at what rate the consumer will revert to saving from his current income. It has been calculated that even if the saving rate were to revert only to 3-4% of disposable income, less than half its postwar average rate, it would make for the deepest and longest recession in modern times. What this will do to corporate fixed investment spending hardly needs explanation. Preventing the recession, by the way, would essentially require recreating the bubble.

ANOTHER MYTH: THE PRODUCTIVITY MIRACLE

Notwithstanding the demise of the Nasdaq and the New Economy hype, the U.S. economy's recorded productivity miracle remains the great theme in Washington and on Wall Street. Mr. Greenspan, in particular, has argued in congressional testimony that productivity resilience could be decisive in cushioning the downside of a U.S. recession.

We have to admit our complete inability to see any logic in this statement. The basic idea inherent to it

seems to be that sustained high productivity growth alleviates cost and margin pressures. The tempered profit squeeze, in turn, is apparently supposed to shore up capital spending despite the economy's slowdown. When he went before a congressional committee in February to reassure anxious lawmakers about the economy, Mr. Greenspan stressed it as an important positive that analysts and executives still expected robust long-term profit growth, at well over 15% by some estimates. *"Most corporate managers appear not to have altered to any appreciable extent their longstanding optimism about the future returns from using new technology,"* Mr. Greenspan said. That, he remarked, *"is likely to underpin continued investment-led growth."*

Strong productivity growth — meaning falling labor costs per unit output — tends to make, indeed, for high profits and low inflation. During the five boom years 1995-2000, recorded productivity growth totaled 17%, averaging 3.4% per year. Being by far the highest productivity growth in the world, it ought to have equally delivered a superior profit and inflation performance.

However, one looks in vain for positive effects of this profit miracle on recorded profits. Fierce competition and lack of pricing power is the general explanation for this failure. But if true, this ought to have shown in particularly low U.S. inflation rates. In reality, they were the highest among industrial countries. Consumer prices are up 14.2% over these five years, averaging 2.8% per year. That's definitely a far cry from eight years of zero inflation during the boom of the 1920s. Nevertheless, corporate profits had performed strongly at the time.

In actual fact, these annual averages conceal a dramatic deterioration in the U.S. inflation picture from 1997-98 to 1999-2000. After an effective slight decline during the first two years in the wake of the Asian-Russian crisis, producer prices increased in the latter two years by 2.9% and 3.6%. **Excluding very weak foods prices, producer prices of consumer goods soared in 1999 by 5.1% and in 2000 by 5.4%, against -1.5% in 1997 and -0.1% in 1998.** Consumer prices advanced 2.7% in 1999 and 3.4% in 2000, after 1.7% in 1997 and 1.6% in 2000. Plainly, the Fed's rate hikes during the latter two years had very good reasons. In today's global environment, America's inflation performance has been mediocre at best.

Noting this sharp uptrend in U.S. inflation, the prevailing complacency about supposedly low inflation is hard to understand. Above all, though, it strikes us that these lofty inflation rates, just as the poor profit growth, are glaringly inconsistent with the story of a productivity miracle. Nor does this story fit in with the collapse of real disposable income growth. Consider that reported productivity growth of 4.3% for all of 2000 was the highest since 1983. Still, real income growth slowed sharply in the second half of the year, while corporate profits even plunged. Record-high productivity growth, if true, would essentially have made for much lower inflation and record-high income and profit growth.

If the stellar rate of productivity growth were true... That is, indeed, the key question about the U.S. economy. Is the sudden jump in productivity growth since 1995 for real, or is it an illusion of measurement? Does it truly reflect a sea change in the U.S. economy's efficiency, or does it largely result from badly flawed statistical measurement of inflation? In a recent article, Professor Paul Krugman writes: *"From the 1970s until the middle of the 1990s, technology was a big disappointment. Nifty gadgets like the fax machine became widely available, yet seemed to do little or nothing for the overall productivity of the economy... Then around 1995 everything changed. For reasons that are still unclear, suddenly all that investment in information technology started to pay off. Those who had called the turn correctly, like Alan Greenspan, looked brilliant, while those of us who had been reluctant to change our views began to feel silly."*

In one of his testimonies to Congress in July of last year, Mr. Greenspan said something about the productivity gains that perfectly characterizes the perversity of the situation, saying, *"These productivity gains have increased potential supply, but have also improved confidence and earnings expectations to such an extent that aggregate demand has soared. An excess of demand growth over supply has led to imbalances."*

In other words, it all started with the stellar productivity numbers. But being taken as conclusive evidence that the new information technology and the new managerial shareholder-value culture were

doing wonders to the U.S. economy, they played a crucial role in generating the general overconfidence and the euphoric expectations that were needed to foster the corporate and consumer borrowing binge.

Understandably, Mr. Greenspan omitted to mention his own role in stoking the mania as a cheerleading New Era apostle not only by providing the requisite, boundless money and credit creation, but also by using public opportunities time and again to bolster the euphoric expectations embodied in the American high-tech bubble.

INFLECTION POINT 1995

We have to correct Mr. Krugman in one point. Yes, everything suddenly changed in 1995. He gets it wrong, though, when he says that the reasons for that sudden change are unclear. They are all too clear, only it takes a little effort to see them. To wit, in that year two very important things happened, not in the economy but in the U.S. price and output statistics.

The first was the introduction of a series of revisions in the inflation indices, owing to recommendations of the Boskin Commission in 1996. Its report had concluded that America's inflation was overstated by an annual rate of 1.1%. Duly, the greater part of this was corrected away by statistical revisions. It may seem a minor change, but it was enough to add substantially to productivity growth and to greatly enhance the general perception of the U.S. economy.

Most importantly, whatever reduces the inflation rate inherently translates into commensurately higher output and productivity growth. In another benchmark revision, the government's statisticians chose to treat computer software as a final capital good rather than an intermediate input. This, too, added to measured output and productivity growth.

But the origin of the most important statistical change goes back to 1986. In that year, after long debate, the U.S. government statisticians decided to measure the output of computer hardware in a new way. It was decided to adjust computer prices for changes in terms of units of computer power and memory. The principal idea behind this so-called hedonic price indexing was to capture and express quality improvements in falling prices.

This measurement has been consistently practiced ever since. Nevertheless, 1995 became a hallmark in the life of the New Economy boom. It arose from an amazing acceleration of the rate of such quality improvements and corresponding price decreases. Between 1995 and 1999, the price of computer equipment bought by businesses declined at a rate of roughly 24% per year. That was almost twice as fast as the 13% annual rate of decline between 1985 and 1995. Prices for the broader category of information technology goods showed much the same pattern with a much faster quality-adjusted decline after 1995 compared to the earlier period.

Though a purely statistical change affecting the inflation rate, it had dramatic effects on measured real output and GDP growth. With nominal GDP growth given, any lowering of the inflation rate commensurately increases real GDP growth, and in its wake also productivity growth. As productivity growth is simply the increase in total output divided by the increase in total hours of labor employed to create that output, measured productivity surged in line with GDP growth. Over time, by the way, the list of hedonically adjusted prices of products has rapidly lengthened. Yet, it's the measuring of high-tech that made all the difference.

What is the overall impact of hedonic price indexing on U.S. output and GDP growth and accordingly also on productivity growth? In a recent speech at the Washington Economic Policy Conference of the National Association for Business Economics, Mr. Greenspan gave some figures that are as amazing as they are shocking: *"In total these high-tech goods... represent less than 8% of total manufacturing output. However, their production, as we measure it, rose at an average annual rate of 50% in the second half of the 1990s, and taken together, they contributed two-thirds of the increase in manufacturing output between 1995 and 2000. Indeed, U.S. production of semiconductors in 1996 eclipsed motor vehicle assemblies as the largest four-digit manufacturing industry in nominal value-added terms."*

THE ROTTEN HEART

For Mr. Greenspan, probably, this enormous rise of high-tech as a share of output growth is a great positive for the economy. Just imagine how much this drastic change in the output mix boosts overall productivity growth. Our own conclusion is extremely negative. To us, it suggests gross overinvestment in information high-tech and gross underinvestment in production plants of the Old Economy. The relationship between the two is certainly absurd. We figured out that the 92% of manufacturing belonging to the Old Economy increased its output during the five years by just 10% overall, or 2% annually.

The pertinent point to see is that most of that extraordinary investment boom in high-tech has accrued from business spending on high-tech investment, measured by hedonic price indexing. Its increase from 1995 to 2000 by altogether \$223 billion accounted for 15% of real GDP. In current dollars, by contrast, computer investment rose just \$43 billion accounting for 2% of nominal GDP growth.

Recalling that annual productivity growth averaged 3.4% during 1995-2000, up from 1%-1.5% earlier, it seems a reasonable guess that the trumpeted American productivity miracle of the last few years arose largely from the massive effects of hedonic price indexing.

These figures make it perfectly clear that the contributions of hedonic price indexing to measured output and productivity growth have played a decisive role in creating the perception of a super-performing U.S. new paradigm economy.

But that leaves us with another pestering question: Does this method of measuring output growth with quality-adjusted prices make good economic sense? After thinking it over, we have come to the conclusion that it's definitely much too important a question to be left for statisticians to decide.

Superficially, it seems to make sense, and as long as it involves minimal price modifications, it's of little relevance. But in the U.S. case, the statistical impact of hedonic price indexing on officially measured real GDP and productivity growth has been so formidable since 1995 that it dramatically changed the perception of the U.S. economy for the better. Not only that, together with the runaway credit creation, the resulting euphoric perception about the New Economy subsequently fuelled the mania in the stock market with the well-known, further massive effects in form of the consumer and business borrowing and spending binges. It can be reasonably said that hedonic price indexing has been the rotten heart of the U.S. bubble economy. Preposterously, a mere statistical change has crucially helped to create the stock market and the bubble economy, spelling later disaster. We would say that this is already enough of a horrible experience to repudiate the use of this price index once and for all.

Yet there is still another compelling argument against "hedonics." Substantial growth in real GDP and productivity intrinsically implies in public opinion a general increase in inflation-adjusted purchasing power and living standards, made available through inflation-adjusted income growth. But the dollars that hedonic price indexing creates in the real GDP accounts are nobody's purchasing power, nobody's expense, nobody's revenue and nobody's cash flow. It happens, that all these things are precisely the ones that crucially matter for business activity. The "hedonic" effects are good for the eye and the perception, but for nothing else.

We come to the decisive flaw in the hedonic concept from a strictly economic perspective. In the United States, arithmetically, it has added massively to reported GDP growth and in its wake also to measured productivity growth. Yet, as pointed out, these are purely statistical effects that nobody notices in his purse. But since these are the two aggregates which the markets and everybody else primarily focuses on as measures of an economy's health and strength, the hedonic price indexing has played an overwhelming role in creating the false perception of an American new paradigm economy.

FORGET THE V

So far, Mr. Greenspan has not revoked his statement from earlier this year that the U.S. economy will stage

a quick V-shaped rebound later this year, and it seems to us that he has lots of company in this belief in the markets, in the media and among economists. Recent rallies in the stock market clearly reflect the same consensus that the Fed can and will solve the economy's difficulties. Just the same, this expectation is also helping the dollar in the currency markets. The currency markets are virtually rewarding the Fed's rate cuts as evidence of a resolve to fight economic weakness. On a trade-weighted basis, the dollar is close to its highest level since 1986 on the apparent assumption that the U.S. rate cuts will promptly revive economic growth. Paradoxically, it apparently undermines the euro because the ECB is dragging its feet on monetary easing despite signs of economic weakness in Germany.

Most remarkably, this belief that the U.S. economy's problems are temporary has been the consensus not only in the United States but around the world. Never mind America's record current-account deficit, goes the argument. It can be easily financed in global financial markets once it becomes apparent that returns on dollar-denominated assets are experiencing only a temporary deviation from their elevated norms of recent years. Of course, the prevailing image of the world is that the U.S. economy offers the highest rates of return globally. Therefore, as everyone knows, the big rush of European companies to acquire U.S. companies.

Apart from the horrible Daimler case, it has found very little publicity that the high-riding profit expectations of foreign-owned firms buying into the U.S. economy are regularly badly disappointed. On average, their rate of return is far below those reported by U.S. companies. We remember an article on this subject some time ago in the Commerce Department's Survey of Current Business. It has its obvious reason in the fact that foreign firms invest disproportionately in U.S. manufacturing where profits are also generally poor for American firms. Foreign firms, along with American manufacturers, suffered a steep decline of their profits in the fourth quarter. Ironically, U.S. firms have been enjoying — see table on page 5 — stellar profit growth from their investments abroad — up 59% since 1995.

HARD OF HEARING ECB

For as long as it has existed, the ECB has been an object of derision for international commentators, drawing degrading comparisons between the bank's president, Mr. Duisenberg, and the godlike Fed chief, Mr. Greenspan. For sure, the former definitely lacks the extraordinary cleverness in public communication that distinguishes the latter. Yet our sympathies always belong to the ECB's unspectacular, steady policy stance, contrasting most favorably with the Fed's extremely activist and reckless pursuit of unbridled money and credit growth. Instead of urging the ECB to ease, the IMF should have urged Mr. Greenspan some time ago to exert some restraint on the U.S. financial system's insane credit expansion, which is the true cause of the U.S. economy's present, frightening problems. By heavily spilling over into the rest of the world, these credit excesses have equally undermined global stability. But who was there to warn?

We guess that European policymakers badly underestimate the risks facing the U.S. economy. But who does not? Just look at Wall Street. The urgency in the international pressure on the ECB contrasts oddly with the complacent economic forecasts from American sources and the IMF. Anybody warning of worse to come is being ridiculed. From this perspective, the ECB might well take a bit more sanguine view of inflation. Considering, however, the notorious, widespread hostility of international commentators, it has every reason to take no risk with its credibility. We wouldn't be astonished if the very same commentators who are now condemning the ECB for its "paralysis" would then condemn it for its "compliance." Besides, what would it do to the world economy if the ECB lowered its rate by 0.25%? It would be just l'art pour l'art.

CONCLUSIONS:

U.S. real economic growth crept up in the first quarter to 0.50% from 0.25% in the fourth quarter of 2000. This was hardly worth mentioning. But the American practice of annualizing these data turned it into a big rebound from 1% to 2%, making headlines in the world press. But its two main sources, a sharp decline in imports and a new record in dissaving by the consumer, were in essence signs of weakness.

This is definitely not the pattern of growth that might usher in a sustained economic recovery. It is critical to realize that the vast, unsustainable imbalances that have accumulated in the U.S. economy during the bubble years make a prolonged, severe recession inevitable. The U.S. economy and its financial system are hostage to ever more inordinate credit excesses. Mr. Greenspan is desperate to recreate the bubble. But his reckless policy has collapsed into uncontrolled credit inflation that has less and less effect on the economy.

The epicenter of the downturn is the collapsing high-tech sector. Though accounting only for a small part of economic activity, it has a controlling impact on the economy and its financial system. Previously it was upwards, now it is downwards. Last but not least, high-tech has been the source of new paradigm euphoria.

The new paradigm euphoria is gone. Yet the perception of the U.S. economy's extraordinary dynamism and superior performance in comparison to other countries remains very much alive. Americans are not alone in this illusion. It is shared around the world. Above all, the dollar's strength hinges on this perception. The nightmare for the dollar and the U.S. financial markets begins when this perception loses its luster.

In 1928 and 1929, the Fed worried about stock speculation. Mr. Greenspan has systematically stoked the mania of the 1990s with unprecedented credit excesses and public speeches endorsing a new era productivity miracle that assures never-ending, strong inflation-free economic growth.

From available figures it emerges that the miraculous productivity improvements in the U.S. economy during the last few years have completely accrued from statistical adjustments, padding real GDP growth.

The moderate slowdown in the euro-zone does not call for drastic rate cuts. In the absence of a borrowing and spending binge, there is no danger of a bust, telecom excesses aside. Given a very small participation of the public in the stock market, wealth effects play a negligible role. Yet repercussions from the U.S. nightmare should not be underestimated. Euro-government bonds are the safe haven in this environment.

AN UNPARALLELED PROFIT OPPORTUNITY

The collapse of the stock market bubble and the coming fall of the dollar present unparalleled profit opportunities. John Myers' *Resource Trader Alert* is in position to take advantage of this unique time in history. His penny stock and option recommendations have already shown some significant successes, including 60% on Swiss franc calls when the dollar showed signs of weakness and 175% in four months when the gold market began to strengthen. To learn more about John Myers and how his *Resource Trader Alert* can help you flourish in these uncertain times, read the special insert in this month's issue.

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